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SIPDIS

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SUBJECT: CHINESE ECONOMIC INVOLVEMENT IN BRAZIL -- LARGELY TRADE-DRIVEN

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F) Brasilia 0212
G) SAO PAULO 0324
H) BRASILIA 2295
I) BRASILIA 2317

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¶1. (SBU) Summary: China's involvement in Brazil's economy primarily is trade-driven. Despite the fanfare and the billion dollar-price-tag investment projects trumpeted during President Hu Jintao's November 11, 2004 visit to Brazil, Chinese investment remains a tiny fraction of FDI in Brazil. By contrast, the trade relationship is much more robust, although not without tensions. China consumed between 5% and 6.2% of Brazilian exports in the last three years and provided between 4.4% and 6.6% of Brazilian imports during the same period. While the trade balance in 2003 and 2004 heavily favored Brazil, Chinese imports increasingly are closing the gap. Growth in imports of Chinese shoes, textiles and toys, for example, have sparked calls for restraints on Chinese imports and resurrected fears over the concession of market status to China during Hu's visit. This, combined with China's opposition to Brazil's bid for a permanent UN Security Council seat, has dulled the luster somewhat of the "strategic partnership" the Lula administration has sought to establish with China. End Summary.

¶2. (SBU) Background: This cable responds to ref A tasking for information on China's involvement in Brazil. Refs H and I covered environmental and political aspects, respectively, of the Brazil-China relationship. This cable examines the economic relationship.

Euphoria Fades with Shrinking Trade Surplus

¶3. (SBU) While geopolitical objectives, such as obtaining a seat on the UN Security Council, underlie Brazil's policy of seeking a "strategic partnership" with China, a boom in Brazil's exports to China in 2003 and 2004 and the expectation of substantial Chinese investment in infrastructure projects in Brazil provided the Lula administration with additional economic rational for actively courting the Asian giant. China's persistently high growth rates and seemingly insatiable demand for inputs to feed that growth fueled images of China as a key partner within the Lula administration's overall strategy of export led growth and greater financial stability through export led current account surpluses. China has also been a key ally for Brazil within the G-20 group of countries, which is pressing for agricultural trade reform within the WTO Doha Development Agenda negotiations.

¶4. (SBU) A surge in Brazilian exports to China in 2003 provided a favorable backdrop for President Lula's trip to Beijing in May 2004, during which President's Lula and Hu discussed the possibility of pursuing Mercosul-China free trade negotiations. Amidst rising expectations of a growing, advantageous trade and investment relationship, President Lula rolled out the red carpet for President Hu during a reciprocal 5-day state visit to Brazil the following November (ref C). At the time, President Lula predicted that trade with China would double within three years, to reach $10 billion. However, talks did not go as the GoB planned, with President Hu leaving with the prize of "market economy" recognition, while avoiding a clear endorsement for Brazil's bid for a permanent UN Security Council seat.

¶5. (SBU) As the "Economist" noted recently, the initial euphoria in Brazil over a strategic partnership with China appears to be giving way to disappointment, and in some quarters, anger and fear. While Chinese officials have characterized Brazilian and Chinese economies (and trade) as "complementary," local analysts and commentators lament Brazil's role as commodity supplier to China while the trade

flow in the opposite direction consists mainly of manufactured and semi-manufactured goods. Considerable blow-back from the Brazilian private sector has put the Mercosul-China trade negotiations project on the GoB backburner, with no date being set for completion of even the terms of reference for a feasibility study. Brazil's agricultural community still smarts over China's rejection of soybean shipments costing millions last year on dubious phytosanitary grounds. Stung by the GoB's acceptance of China's demand for market economy recognition, and fearful of rising Chinese imports, Brazil's private sector has been clamoring for a more circumspect approach by the GoB to commercial relations with China (refs D, F and G).

¶6. (SBU) With China's opposition to the G-4 proposal on UN Security Council expansion and Brazil's shrinking trade surplus with China, calls to reevaluate the bilateral trade relationship appear to be gaining traction within the GoB. Registering "disappointment" with China's position on Brazil's bid for a UN Security Council seat, Foreign Minister Amorim recently told the press a decision to renege on Brazil's promise to recognize China as a market economy could only be taken at the presidential level. Nonetheless, the GoB has already put "on-hold" promulgation of the relevant implementing regulations.

¶7. (SBU) In response to private sector concerns, the GoB is also considering measures to restrict rising Chinese imports of textiles and apparel, shoes, machinery, toys, and optical lenses. While China has suggested the possibility of negotiating voluntary export restraints during the upcoming visit to Beijing of Minister of Development, Industry and Trade Furlan, the GoB claims the application of safeguards is a "parallel" process. Minister Furlan himself has stated that a decree to permit safeguards against certain Chinese products will be finalized prior to his departure for China on September 15. An agreement with Argentina in August to share information on Chinese imports, presumably for better policy coordination, also appears designed to strengthen Brazil's hand in managing its trade relationship with China.

¶8. (SBU) When, and under what circumstances, safeguards would actually be imposed, however, remains an open question. Recently, Foreign Ministry trade experts told a visiting U.S. Congressional staff delegation that surges in Chinese imports only appear to be taking place in certain subcategories of textiles and footwear -- and not across the broad range of such goods. The textile and apparel sector, which absorbed a 47 percent increase in Chinese imports from January through July of this year, claims problems are particularly acute for polyester cloth, women's synthetic material sweatpants and men's cotton sweatpants. For shoes, problem products include cloth sneakers, shoes made from synthetic material and some types of men's leather shoes. Under the machinery heading, protection is being sought for plastic injection machines.

¶9. (SBU) All in all, China will no doubt remain one of Brazil's top export markets and an important trade partner for Brazil for the foreseeable future. However, the GoB's expectations regarding this relationship appear to be undergoing an adjustment to reflect a more realistic assessment of related national interests and policies.

Trade Statistics

¶10. (SBU) In the late 1990s, two-way trade between Brazil and China was relatively balanced and hovered around $2.2 billion (see statistics below), except for a disruption in late 1998/199 due to Brazilian financial difficulties. After recovering in 2000 to previous trade levels, Brazil's exports to China took off, pulling up two-way trade figures. By 2002, total trade between the two countries had almost doubled to $4.1 billion, fueled by a 132 percent increase in Brazil's exports to China over the two-year period. A further 86 percent leap in Brazilian exports in 2003 bumped two-way trade up to $6.7 billion making China Brazil's fourth largest export destination and overall trading partner. Brazil's trade surplus with China in 2003 stood at a record $2.4 billion.

¶11. (U) Although overall trade has continued to grow, and China now stands as Brazil's third largest export market (fourth if the EU is considered as a bloc), 2004 was a turning point as growth in imports from China (73 percent) substantially outpaced growth of trade in the opposite direction (20 percent). That trend has strengthened in 2005; imports from China during the first seven months of the year increased by 47 percent compared to the same period in 2004, while exports to China increased by only 4 percent. As a result, Brazil's trade surplus with China through July 2005 ($0.73 billion) is down by one-half from the same period the previous year. Imports from China increased at a rate well above the average of 18 percent registered for Brazil's total imports for the first seven months of this

year.

¶12. (U) The composition of Brazil's exports to China is heavily weighted toward primary products with soybeans and iron ore together accounting for slightly more than half; China remains Brazil's number one export market for these products. Other top exports to China include steel, crude oil, soybean oil, leather, chemical pastes from wood, and poultry. In contrast, Brazil's imports from China tend to be manufactured or semi-manufactured products. Top imports from China include cellular telephones and parts, computers and parts, liquid crystal devices, integrated circuits, cloth and certain chemicals.

TABLE I
Brazil-China Overall Trade
(USD Million)

	Exports	Imports	Total	Surplus/ Deficit)
1995	1.204	1.042	2.246	0.162
1996	1.114	1.133	2.247	(0.019)
1997	1.088	1.166	2.254	(0.078)
1998	0.905	1.034	1.939	(0.129)
1999	0.676	0.865	1.541	(0.189)
2000	1.085	1.222	2.307	(0.137)
2001	1.902	1.328	3.230	0.574
2002	2.520	1.554	4.074	0.966
2003	4.533	2.147	6.668	2.386
2004	5.440	3.711	9.151	1.729
2004(1)	3.352	1.871	5.223	1.481
2005(1)	3.489	2.755	6.244	0.734

(1) January through July.

Source: Ministry of Development and Trade, AliceWeb database (http://aliceweb.mdic.gov.br).

Steel and Steel Products

¶13. (U) Steel and steel product exports to China peaked in 2003 reaching almost $730 million. Although exports of these products fell by almost one-half in 2004, they still accounted for around 7 percent of Brazil's exports to China in value.

TABLE II
Steel Trade by Value
(Value - USD 1,000)

	Exports	Imports
2000	27,665	5,931
2001	46,342	4,474
2002	128,720	4,651
2003	729,558	4,593
2004	367,535	12,160

TABLE II
Steel Trade by Volume
(Quantity - metric tons)

	Exports	Imports
2000	86,817	13,436
2001	164,153	3,385
2002	464,297	3,517
2003	2,422,777	3,561
2004	988,137	9,617

Source: Brazilian Steel Institute Databook, 2001-2005.

Iron Ore

¶14. (U) Trade in iron ore is one-way to China and has been growing substantially since 2000. In 2004, iron ore exports accounted for 20 percent of Brazil's exports to China.

TABLE IV
Iron Ore Exports
(USD 1,000)

1996	43,648
1997	179,432
1998	440,876
1999	241,177
2000	271,192
2001	482,633
2002	597,225
2003	764,857
2004	1,114,956
2005(1)	809,688

(1) January through July.

Source: Ministry of Development and Trade, AliceWeb database (http://aliceweb.mdic.gov.br).

Energy

¶15. (U) Bilateral trade in liquid natural gas and coal has been minimal. However, Companía Vale do Rio Doce (CVRD), the world's top iron ore mining company, reportedly is studying the use of coal to supply its energy needs after experiencing problems obtaining environmental permits for hydroelectric power projects; CVRD could import coal from its coal project in China. Brazilian exports of crude petroleum to China increased eight-fold in 2004 and in the first seven months of 2005 are already running 42 percent higher that exports for all of last year.

TABLE V
Crude Petroleum Exports
(Value-USD 1,000)

2000	36,124
2001	39,847
2002	0
2003	22,266
2004	178,338
2005(1)	254,106

(1) January through July.

Source: Ministry of Development and Trade, AliceWeb database (http://aliceweb.mdic.gov.br).

Timber and Timber Products (not including furniture)

¶16. (U) Imports of timber and timber products from China are low and stable. Brazilian exports of timber and timber products appear to have stabilized after increasing 56 percent between 2002 and 2003.

TABLE VI
Timber Products Trade
(Value-USD 1,000)

	Exports	Imports
1996	1,029	1,343
1997	1,550	1,909
1998	2,084	2,620
1999	9,334	1,216
2000	33,734	1,166
2001	46,223	1,007
2002	78,254	1,414
2003	122,144	1,400
2004	137,044	2,733
2005(1)	74,746	1,193

(1) January through July.

Source: Ministry of Development and Trade, AliceWeb database (http://aliceweb.mdic.gov.br).

Cement

¶17. (U) Brazilian exports of cement to China are negligible. The value of Brazilian imports of cement from China remains low; after tripling in 2003, the level has remained relatively stable.

TABLE VII
Cement Imports
(USD 1,000)

1999	3
2000	2
2001	0
2002	56
2003	165
2004	155
2005(1)	106

(1) January through July.

Source: Ministry of Development and Trade, AliceWeb database (http://aliceweb.mdic.gov.br).

Investment: Show me the Money

¶18. (U) As the GoB does not track contracted investment, it is difficult to get a firm picture of China's investment plans in Brazil. Based on published accounts, six commercial agreements were discussed during Hu's visit in November 2004 (ref C). These included:

1) A cooperation agreement between China's Eximbank and China Petrochemical Corporation (SINOPEC) and Brazil's Development Bank (BNDES) and Petrobras in a $1.3 billion Gasene project to run a gas pipeline from Rio de Janeiro to Bahia;
2) An agreement between Companhia Vale do Rio Doce (CVRD) and Yongcheng Coal and Electricity and Shanghai Baosteel;
3) A joint venture to produce alumina between CVRD and Aluminum Corporation of China;
4) A joint venture between ZhuZhou Rolling Stock Works and Mitsui and the Metal Mechanic Consortium of Espirito Santo to produce rail cars;
5) A basic accord between Electrobras, Companhia de Geracao Termica de Energia Electrica, Citic Group, and China Development Bank; and,
6) Purchase of Chinese equipment by Cosipar, financed by the Import Bank of China.

¶19. (U) The breathless headlines of the moment put the total value of these deals at over $10 billion (to be invested over several years). Since most of these projects are joint ventures and we do not have breakdowns of the Chinese investment/financing commitments under each project, the actual level of expected/planned Chinese investment likely is significantly lower. Brazilian Central Bank data on monthly Chinese investment flows in 2005 does not show a significant increase in Chinese direct investment since the Hu visit. Based on flows through June 2005, Chinese investment is on a course to exceed $10 million for the year as a whole but this would still be below 2001-2004 average Chinese FDI of $14.4 million per year.

Policy Support

¶20. (SBU) The negotiation of the proposals and deals associated with the Hu visit had significant official PRC policy support and some offers of official PRC financing. The unique context of these proposals/deals, which were seen as deliverables for Hu's visit, makes it hazardous to generalize from these cases about the overall level of Chinese government policy support for Chinese investments in Brazil.

(U) Table VIII
Chinese Direct Investment in Brazil

Year	US$ Million	Percent of Total
1985 (Stock)	3.0	less than 0.1
1995 (Stock)	27.9	0.67
2000 (Stock)	37.7	less than 0.1
2001 (Annual Flow)	28.1	0.13
2002 (Annual Flow)	9.7	less than 0.1
2003 (Annual Flow)	15.5	0.12
2004 (Annual Flow)	4.4	less than 0.1
2005 (Flow through June)	5.1	less than 0.1

Source: Central Bank (1985, 1995 and 2000 stock data based on formal FDI survey; 2001-2005 flow data based on balance of payments data.)

¶21. (SBU) While the pace of Chinese investment in Brazil undeniably has picked up since 2000, China remains a tiny player among foreign investors in Brazil, a country which has attracted an average of slightly over $20 billion in FDI every year since 1996 (and never less than $10 billion during that period). Based on Central Bank data, it appears that Chinese investment as a percentage of total FDI in Brazil was at a peak in 1995 and has fallen since then. While the Central Bank data would not count as Chinese any Chinese capital that flowed through an offshore tax haven (e.g. Bahamas, Isle of Mann), GoB officials have told us they believe that much of the money that flows into Brazil from such offshore havens is repatriated Brazilian capital. We do not have hard data on Chinese portfolio investment flows, but based on our contacts in Brazilian financial markets, do not believe these flows to be significant.

(U) TABLE IX
Chinese FDI in Brazil
Distribution by Sector
2000-2004 Flows
(Percent)

Wholesale Commerce	17.6

Construction	4.3
Mining	37.0
Manufacturing of:	
- Plastics/Rubber	4.1
- Machinery/Equipment	23.0
Others	14.0

Source: Central Bank Balance of Payments Data

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